

THE SUBPRIME MORTGAGE CRISIS, DIRECTORS AND OFFICERS INSURANCE, AND PERSONAL LIABILITY

SACHIYO ISODA*

I. INTRODUCTION

On September 7, 2008, the Federal National Mortgage Association, more commonly known as Fannie Mae, and the Federal Home Loan Mortgage Corporation, known as Freddie Mac, were placed into conservatorship, marking one of the most drastic government interventions in the private financial market in decades.¹ The two entities together had \$5.4 trillion of guaranteed, mortgage-backed securities (“MBS”) and debt outstanding, and their market share of all new mortgages reached over 80% earlier in 2008.² The startling federal takeover of Fannie Mae and Freddie Mac was followed by the sale of Merrill Lynch to Bank of America, the Lehman Brothers collapse, and an \$85 billion federal loan to American International Group to avoid bankruptcy.³ Most troubling, the week of October 6, 2008, was one of the worst weeks for the stock market with the Standard and Poor’s 500-stock index and the Dow Jones industrial average each losing 18% of their value.⁴

*Juris Doctor Candidate 2010, The Ohio State University Moritz College of Law.

¹ Zachary A. Goldfarb, David Cho, & Binyamin Appelbaum, *Treasury to Rescue Fannie and Freddie; Regulators Seek to Keep Firms’ Troubles From Setting Off Wave of Bank Failures*, WASH. POST, Sept. 7, 2008, at A1. According to the Federal Housing Finance Agency, “A conservatorship is the legal process in which a person or entity is appointed to establish control and oversight of a Company to put it in a sound and solvent condition. In a conservatorship, the powers of the Company’s directors, officers, and shareholders are transferred to the designated Conservator.” See Federal Housing Finance Agency, *Questions and Answers on Conservatorship*, available at http://www.treas.gov/press/releases/reports/fhfa_consrv_faq_090708hp1128.pdf (last visited May 12, 2009).

² James B. Lockhart, Director, Fed. Housing Fin. Agency, Press Conference. (Sept. 7, 2008).

³ Andrew Ross Sorkin, *Bids to Halt Financial Crisis Reshape Landscape of Wall St.*, N.Y. TIMES, Sept. 15, 2008; Edmund L. Andrews, Michael J. de la Merced & Mary Williams Walsh, *Fed in an \$85 Billion Rescue of an Insurer Near Failure*, N.Y. TIMES, Sept. 17, 2008, at A1.

⁴ Renae Merle, *Worst Week Ever: Dow, S&P Each Fall 18%*, WASH. POST, Oct. 11, 2008, at D1.

Most economists believe the root of the current financial meltdown is the subprime mortgage crisis.⁵ The subprime mortgage crisis resulted from a number of factors: the housing bubble, government and federal regulatory policies, increased subprime lending and other risky mortgage products, deceptive borrowers, and the fall of the housing market.⁶ Some blame the lenders for making loans to high-risk borrowers, whom the lenders should have known would not be able to pay the loans back, and naively assuming that the housing market would continue to get better.⁷ Others point a finger at the investment banks, which turned the subprime loans into low-risk collateralized debt obligations ("CDOs"), superficially encouraging investors to part with their money.⁸ Yet others place the blame on the subprime borrowers themselves for borrowing money to buy houses they clearly could not afford, sometimes doing so by lying about their income to receive the loans.⁹ Other critics blame the Federal Reserve Board ("Fed") and Alan Greenspan's policy of lowering interest rates after the dot-com bubble crash, stating that the Fed was misguided by erroneously low inflation data.¹⁰ Most likely, all of these elements, combined with the housing slump, led to the subprime mortgage crisis.¹¹ The details of the subprime mortgage crisis are discussed in Part II of this note.

As of March 16, 2009, 172 subprime and credit crisis-related securities suits have been filed, thirty of which were filed in 2009.¹² Many of these lawsuits involve not only the lending companies, but also the directors and officers of those companies. Although Directors and Officers Insurance ("D&O Insurance") will cover much of the personal liability that directors and officers could be exposed to, there are many exceptions. These exceptions are outlined in Part IV of this note. This note will explore the possibility of personal liability for directors and officers of a company, despite the purchase of D&O insurance.

⁵ The Economist, *When Fortune Frowned*, THE ECONOMIST, Oct. 9, 2008, available at http://www.economist.com/specialreports/displaystory.cfm?story_id=12373696.

⁶ Katalina M. Bianco, *The Subprime Lending Crisis: Causes and Effects of the Mortgage Meltdown*, FED. BANKING L. REP. (CCH), 2008.

⁷ Daniel W. Gerber, Joanna M. Roberto, and Carrie P. Appler, *Coverage Implications of the Subprime-Mortgage Meltdown*, 1-2 MEALEY'S MORTGAGE LENDING 23, Nov. 2007.

⁸ *Id.*

⁹ *Id.*

¹⁰ Bianco, *supra* note 6, at 4-5.

¹¹ Matthew R. Wildermuth, *Wildermuth on Subprime Mortgage Crisis and D&O Insurance*, 2008 EMERGING ISSUES 112, Apr. 7, 2008.

¹² The D&O Diary, <http://www.dandodiary.com/> (Jan. 29, 2009).

II. BACKGROUND

The housing bubble began after the dot-com bubble crash in 2000 and the subsequent recession that began in 2001. The Fed cut short-term interest rates from 6.5 % to 1% in an effort to boost the economy.¹³ This sharp decline in the already historically low interest rate led to rapid increases in the valuations of real property, causing a peak in 2005.¹⁴

In 2000 and again in 2005, the Department of Housing and Urban Development forced Fannie Mae and Freddie Mac to increase the target percentage of mortgage financing directed towards borrowers with incomes below the median in their area.¹⁵ Fannie Mae and Freddie Mac both met these goals. Furthermore, in 2005, a change was made to the Community Reinvestment Act, encouraging banks to lend to consumers who traditionally would not qualify for loans in an effort to fulfill the American dream of home ownership for all.¹⁶

Private lenders and investment banks saw this as an opportunity and embarked on a joint mission to make a profit.¹⁷ During the 1970s, regulated, traditional banks contributed 60% of the mortgage market.¹⁸ However, the rise of subprime lending has steadily decreased this number, to the point that traditional lenders now hold only 10% of the market.¹⁹ The share held by

¹³ Bianco, *supra* note 6, at 4.

¹⁴ Bianco, *supra* note 6, at 6; Many homeowners took advantage of the increased valuations of their homes and refinanced with lower interest rates, taking out second mortgages against the added value to use for consumer spending. *Id.*

¹⁵ Russell Roberts, *How Government Stoked the Mania*, WALL ST. J., Oct. 3, 2008, at A21.

¹⁶ Bianco, *supra* note 6, at 11; With the interest rate being so low, people who could not afford homes prior were able to buy homes, which led to an increase in home ownership in the United States from 64% in 1994 to an all-time high of 69.2% in 2004. *See Id.* at 11-12. Before year 2000, home buyers would pay a down payment on a home and borrow the rest of the money from a single bank, which they would repay until the loan was extinguished. *See* Bill Marsh, *Housing Busts and Hedge Fund Meltdowns: A Spectator's Guide*, N.Y. TIMES, Aug. 5, 2007, available at http://www.nytimes.com/imagepages/2007/08/05/weekinreview/20070805_LOAN_GRAPHIC.html. The borrowers would have to be credit worthy in order to obtain these loans, and the loans are known as prime loans. However, since 2000, many of these loans have been sold to investment banks, which transform the loans into mortgaged-backed securities to sell to investors. *Id.* Although the buyers still repay the same single bank, the risk attached to their mortgage is spread around and repackaged. The type of mortgage that results is what is known as a subprime loan. *Id.*

¹⁷ *Id.*

¹⁸ Bianco, *supra* note 6, at 7.

¹⁹ *Id.* Under banking regulations, subprime borrowers tend to be individuals who have a FICO score of 660 or lower, have two or more 30-day delinquent payments in the past year, a foreclosure or charge-off in the past 2 years, have declared bankruptcy in the last 5 years, and have limited ability to cover monthly living expenses. Melissa M. Ezarik, *Are you a subprime borrower?*, BANKRATE.COM,

commercial banks has grown from virtually nothing to 40% of the entire market, a disturbingly large increase.²⁰

To cover the risk for making loans to high-risk borrowers, the lenders often increased the interest rate on the loans.²¹ Other lenders and brokers aggressively marketed adjustable rate mortgages (“ARMs”)—loans that had a fixed interest rate for the first two to three years then “reset” and dramatically increased.²² Because mortgage brokers do not lend their own money, there was no direct correlation between loan performance and compensation for them.²³ In fact, mortgage brokers had more incentive to sell complex ARM loans because they earned a higher commission.²⁴ Lenders also offered reduced documentation loans or “no doc” loans—a subset of Alt-A loans, which are loans categorized between subprime and prime—in which the borrower did not have to provide documentation to substantiate the income stated on the application.²⁵

The lenders would then sell the riskier mortgages to investment banks, which would turn them into mortgage-backed securities, and the lenders would use the money to make more subprime loans.²⁶ The investment banks then transformed the high-risk pieces of the loans into low-risk by taking the risky pieces of multiple securities and creating a new security called a collateralized debt obligation. A CDO has the same structure as a mortgage-backed security, but a CDO has a superficially low risk rating.²⁷ Some critics of the subprime mortgage crisis claim that conflicts of interest were involved with these ratings because many rating agencies were being paid by the companies selling MBS to investors, such as investment banks.²⁸ Because many investors do not fully perform research on these bonds due to high cost and complexity of the process, they only looked at risk ratings produced by ratings agencies.²⁹

2008, <http://www.bankrate.com/brm/news/debt/debtcreditguide/subprime-trend1.asp>. Although other lenders such as private mortgage bankers have different definitions for subprime loan borrowers, this provides a general picture—one that is less than ideal for a lender. *Id.*

²⁰ Bianco, *supra* note 6, at 7.

²¹ Gerber, Roberto, & Appler, *supra* note 7, at 1-2.

²² Robert Jaworski, *The Perfect Storm: Legal Issues Surrounding the Subprime Mortgage Lending Crisis*, LEXISNEXIS EXPERT COMMENTARIES (LexisNexis), 2008, at 1.

²³ Bianco, *supra* note 6, at 8.

²⁴ *Id.* A study has found that in 2004, mortgage brokers originated 68% of all residential loans in the United States, with subprime and Alt-A accounting for over 42% of the 68%.

²⁵ *Id.* at 7. Further incentive was created for the lenders with a decline in risk premiums required to offer a subprime loan despite the decline in subprime borrower and loan characteristics overall during 2001 to 2006. *Id.* at 6-7.

²⁶ Marsh, *supra* note 15.

²⁷ *Id.*

²⁸ Bianco, *supra* note 6, at 9.

²⁹ *Id.*

By 2005, nearly one out of every four mortgages was subprime.³⁰ However, between 2004 and 2006, the Fed raised the interest rate a total of seventeen times, increasing the 1% interest rate back up to 5.25%.³¹ Millions of the existing loans with a two to three year adjustable rate began resetting to higher interest rates, and many people began to default on their loans.³² Some homeowners stopped paying their mortgages and walked away, allowing foreclosure of their property.³³ Lenders were also hurt by the increasing number of foreclosures as legal fees, taxes due until the property was sold, and lost equity in houses that had to be priced to sell in a falling market added up.³⁴ A number of subprime mortgage lenders, including Ameriquest, New Century Financial Corporation, and Fremont General either left the market, became insolvent, or declared bankruptcy.³⁵

By August 2006, there were slumping sales and prices in the housing market, essentially leaving the housing sector in a “free fall.”³⁶ The added inventory of unsold homes further weakened the local housing markets and depressed the values of other nearby homes.³⁷ The sale of new homes fell in February 2008 for the fourth straight month, pushing activity to a thirteen year low.³⁸

III. THEORIES OF LIABILITY FOR DIRECTORS AND OFFICERS

Of the many suits that have been filed as a result of the subprime mortgage crisis, some have been filed by cities and state attorney generals against lenders under a predatory lending theory, violation of the Consumer Sales Practices Act, and public nuisance.³⁹ The Commonwealth of Massachusetts succeeded in its suit against Fremont Investment and Loan brought by the Attorney General alleging that the defendant lender committed unfair and deceptive acts in originating and servicing certain subprime mortgage loans.⁴⁰ Although Fremont Investment and Loan appealed, the lower court’s decision was affirmed and the injunction, which restricted

³⁰ Gerber, Roberto, & Appler, *supra* note 7.

³¹ Bianco, *supra* note 6, at 5.

³² *Id.* at 14-15.

³³ *Id.* at 10.

³⁴ *Id.* at 15.

³⁵ Gerber, Roberto, & Appler, *supra* note 7.

³⁶ Bianco, *supra* note 6, at 5.

³⁷ *Id.* at 15. At this point, the median price of new homes had dropped about 3% since January of the same year. *Id.*

³⁸ *Id.* at 18.

³⁹ Jay Miller, *Ohio Chases the Predators*, CRAIN’S CLEVELAND BUSINESS, June 2007; Complaint, City of Cleveland v. Deutsche Bank Trust Company, et. al., (CV 08 646970). The city of Cleveland alleges in its complaint that the epidemic of foreclosures has devalued homes, depleted the city’s tax base, and has therefore created a public nuisance, causing the city to incur a vast amount in damages. *Id.*

⁴⁰ Com. v. Fremont Investment and Loan, 897 N.E.2d 548, 550-51 (Mass. 2008).

Fremont's ability to foreclose on certain loans, was viewed in favor of the public interest.⁴¹

However, most of the suits that have been filed are shareholder derivative suits that concern violations of the Securities Act of 1933, particularly section 11 and section 12(a)(2).⁴² Others concern violations of the Securities Exchange Act of 1934 § 10(b), allegations of insider trading, breach of the duty of care, breach of the duty to monitor, and breach of the duty of loyalty. The shareholder derivative suits often involve not only the company, but also the directors and officers of the corporations as defendants.

A. *Securities Act of 1933*

The Securities Act of 1933 ("Securities Act") requires a corporation to file a registration statement with the Securities Exchange Commission ("SEC") and have it approved before it makes a public offering of stock to shareholders.⁴³ The registration statement includes a prospectus, which is delivered to the securities market, and also to each investor who purchases stock in the company.⁴⁴

1. *Section 11*

Section 11 of the Securities Act gives a private cause of action when a registration statement, prospectus, or other information required by section 7 of the Securities Act and the regulations promulgated thereunder "contains an untrue statement of material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading."⁴⁵ Section 11 imposes a "stringent standard of liability," and liability arises only for statements that were false or misleading at the time the registration statement became effective.⁴⁶

A fact is considered to be material if a reasonable investor would consider it to be significant in making an investment decision.⁴⁷ Materiality does not depend on the literal truth of the statements but rather on the ability of

⁴¹ *Id.* at 561.

⁴² Some examples include suits filed against Merrill Lynch & Co., Countrywide Financial Corp., and Citigroup Inc.

⁴³ WILLIAM A. KLEIN AND JOHN C. COFFEE, JR., *BUSINESS ORGANIZATION AND FINANCE LEGAL AND ECONOMIC PRINCIPLES*, 204 (8th ed., Foundation Press 2002) (1980).

⁴⁴ *Id.*

⁴⁵ 15 U.S.C. § 77k(a) (2008).

⁴⁶ *Id.*

⁴⁷ Thomas Lee Hazen, *Remedies For Violation Of The Securities Act Of 1933 (And Other Consequences Of Deficient Registration Statements)*, in 2 *LAW OF SECURITIES REGULATION* § 7.3[1][A] (6th ed. Thomson Reuters, 2009).

a reasonable investor to become accurately informed about the statement.⁴⁸ When assessing whether a fact is material, the courts consider the entirety of the statements in question including information that is circulated through the media, the efficiency of the market, and the extent to which the available information is absorbed and reflected in the market price of the stock.⁴⁹ Furthermore, materiality is determined as of the date of the offering, and not by using hindsight that may be gained from subsequent events.⁵⁰

A Section 11 claim can be brought against every person who signed the registration statement, every person who was a director of the issuer at the time the registration statement was filed, every person who prepared or certified any report or valuation that was used in connection with the registration statement, and every underwriter of the security in question.⁵¹ Officers who are not also directors are only liable under Section 11 if they signed the registration statement.⁵²

In order to enforce liability under Section 11, a plaintiff must have purchased a security in reliance on the registration statement, and must prove that the stock in question is traceable to the allegedly defective prospectus or registration statement.⁵³ It is not sufficient to use statistical evidence to

⁴⁸ *Id.*

⁴⁹ *Id.*; In other words, the courts ask whether the defendants' representations or omissions, considered together in context, would affect the total mix of information available to the public and thereby mislead a reasonable investor. *Halperin v. eBanker Usa.com, Inc.*, 295 F.3d 352, 357 (2d Cir. 2002).

⁵⁰ *Hazen*, *supra* note 47.

⁵¹ 15 U.S.C. § 77k(a) (2008).

⁵² William Meade Fletcher, *Liability for false registration statements under Section 11*, in 14 FLETCHER CYCLOPEDIA OF THE LAW OF CORPORATIONS § 6850 (Thomson Reuters/West, 2008).

⁵³ *Id.* Actual reliance on the statement does not need to be proved, nor does the plaintiff need to show any causal connection between the misrepresentation or omission and the price decline of the security in question. Edward Brodsky and M. Patricia Adamski, *Reliance*, LAW OF CORPORATE OFFICERS AND DIRECTORS: RIGHTS, DUTIES AND LIABILITIES § 11:18 (Thomson Reuters/West, 2008). The only exception that the showing of actual reliance is necessary that is uniformly accepted by all courts is if the plaintiff

acquired the security after the issuer has made generally available to its security holders an earnings statement covering a period of at least 12 months beginning after the effective date of the registration statement, then the right of recovery under this subsection shall be conditioned on proof that such person acquired the security relying upon such untrue statement in the registration statement or relying upon the registration statement and not knowing of such omission, but such reliance may be established without proof of the reading of the registration statement by such person.

15 U.S.C. § 77k(a) (2008). The Eleventh Circuit has also held that the presumption of reliance is not available when the plaintiff had legally

demonstrate a high probability that the plaintiff purchased securities that were traceable to the securities offered under the registration statement.⁵⁴ Furthermore, the purchaser does not need to prove that he or she actually read the registration statement in order to establish reliance.⁵⁵ Because the plaintiff must be the purchaser of the securities, an acquiring corporation in a merger would not qualify as a Section 11 plaintiff.⁵⁶

Before filing a complaint, the plaintiff must make sure that the statute of limitations has not run.⁵⁷ A Section 11 claim must be brought within one year of discovery or constructive knowledge of the misstatement or omission, and no later than three years after the security was offered to the public.⁵⁸ A plaintiff must allege that the claim is not time-barred by alleging: (1) the time and circumstance of the discovery of the misstatement or omission, (2) the reasons why it was not discovered earlier, and (3) the efforts taken by plaintiff in making or seeking such discovery.⁵⁹

When the plaintiff is ready to file a complaint, there is no uniformity in the courts as to whether the heightened pleading requirement under Rule 9(b) of the Federal Rules of Civil Procedure should apply.⁶⁰ The Second Circuit and the Ninth Circuit have taken the approach that a Section 11 claim is subject to a heightened pleading standard if the complaint is "sound in fraud."⁶¹ However, opponents believe that there is difficulty in applying this standard in a Section 11 claim because it is not clear whether a claim is "sound in fraud."⁶² Because neither fraud nor scienter are elements of a Section 11 claim, a claim can be sufficiently plead without pleading fraud.⁶³ In other words, "while a heightened pleading requirement for fraud makes sense for a statutory claim explicitly *dependent* on a showing of fraud, there can be no comparable reason for upping the ante for a Section 11 claim which can be

committed to invest in the securities before the issuance of the registration statement. *APA Excelsior III L.P. v. Premiere Tech., Inc.*, 476 F.3d 1261, 1276 (11th Cir. 2007).

⁵⁴ *Hazen*, *supra* note 47, at § 7.3[5].

⁵⁵ *Id.*, at § 7.3[4].

⁵⁶ *Fletcher*, *supra* note 52.

⁵⁷ John J. Clarke, Jr. and Lisa Firenze, *Due Diligence and Potential Liabilities*, CORPORATE LAW AND PRACTICE COURSE HANDBOOK SERIES (2008).

⁵⁸ 15 U.S.C. § 77k(a) (2008).

⁵⁹ *See* *Dorchester Investors v. Peak Int'l Ltd.*, 134 F. Supp. 2d 569, 578 (S.D.N.Y. 2001).

⁶⁰ *Hazen*, *supra* note 47, at § 7.3[7]. Rule 9(b) states:

"(b) Fraud or Mistake; Condition of Mind. In alleging fraud or mistake, a party must state *with particularity* the circumstances constituting fraud or mistake. Malice, intent, knowledge, and other conditions of a person's mind may be alleged generally." (emphasis added). FED.R.CIV.P. 9(b).

⁶¹ *Id.*.

⁶² *Id.*

⁶³ *Id.*

based on negligence.”⁶⁴ Regardless of whether it is procedurally efficient to require a heightened pleading or not, plaintiff lawyers should be as particular as possible when alleging a Section 11 claim.⁶⁵

For instance, a class action suit was filed in California against New Century Financial Corporation and its various officers, directors, underwriters, and auditors for violating section 11 and section 12 of the Securities Act in relation to the subprime mortgage crisis.⁶⁶ The defendants’ various motions to dismiss were granted because the plaintiffs’ complaint failed to clearly identify the allegedly false statements or “which of the factual allegations support an inference that particular statements are false or misleading.”⁶⁷ In order for a plaintiff to defeat a defendant’s motion to dismiss, the court recommended that the plaintiff be “clear and concise in identifying false statements and articulating the factual allegations supporting an inference that the statement is false or misleading.”⁶⁸ In addition, the court required the plaintiff to identify facts supporting its allegations that a statement is false or misleading, and to place such supporting facts in the same paragraph or following the statement.⁶⁹

If a plaintiff is successful in pleading a Section 11 claim, there are three methods for computing damages.⁷⁰ Under Section 11(e), a plaintiff can recover the difference between the amount paid for the securities (not to exceed the public offering price) and (1) the value at the time of suit, (2) the price at which plaintiff sold the securities prior to suit, or (3) the price at which the security was sold after suit was brought but before judgment, so long as the damages computed under this third alternative would be less than those based on the difference between the price paid for the security (not to exceed the offering price) and the value at the time suit was brought.⁷¹

The burden of proving the absence of a causal connection lies with the defendant, so loss causation does not need to be shown in order for the plaintiff to establish a *prima facie* case.⁷² However, to the extent the defendant is able to establish loss causation, damages will not be recoverable under Section 11.⁷³ Therefore, if the defendant is able to show that the entire decline in the stock price was due to external market forces, there will be no damages.⁷⁴

⁶⁴ *Id.*

⁶⁵ *Id.*

⁶⁶ *Gold v. Morrice, et al.*, 2008 WL 467619 (C.D.Cal. 2008).

⁶⁷ *Id.* at *2.

⁶⁸ *Id.* at *3.

⁶⁹ *Id.*

⁷⁰ Hazen, *supra* note 47, at § 7.3[8].

⁷¹ 15 U.S.C. § 77k(a) (2008).

⁷² Hazen, *supra* note 47, at § 7.3[8].

⁷³ *Id.*

⁷⁴ *Id.*

Another defense to a Section 11 claim is the due diligence defense.⁷⁵ Defendants other than the issuer can avoid liability under Section 11 if they can demonstrate that they conducted a reasonable investigation with regard to the portions of the registration statement for which they were responsible.⁷⁶ How much due diligence is necessary or appropriate, or what constitutes a “reasonable investigation,” depends on the specific facts and circumstances at hand.⁷⁷ There is a different standard for non-expert defendants as compared to expert defendants, as well as varying protocols for different parts of the registration statement and whether the challenged portion of the registration statement has been made in part or in whole on the authority of an expert.⁷⁸

For the portions of a registration statement that are not made “on the authority of an expert,” a non-expert defendant must show that he or she “had, after reasonable investigation, reasonable ground to believe and did believe” that the relevant part of the registration statement that became effective contained no material misstatement or omission.⁷⁹ Portions of a registration statement that are not made “on the authority of an expert” include the description of the registrant, its history, its structure, and its business.⁸⁰

As for the sections of the registration statement that were made with the assistance of an expert, a non-expert defendant will not be held liable for such statements if such defendants show under the burden of proof that, at the time the registration statement became effective, they had “no reasonable ground to believe and did not believe” that a material misstatement or omission existed.⁸¹ The standard for determining reasonable investigation and reasonable grounds for belief is “the standard of reasonableness...required of a prudent man in the management of his own property.”⁸²

⁷⁵ Clarke, *supra* note 57.

⁷⁶ 15 U.S.C. § 77k(b) (2008).

⁷⁷ Clarke, *supra* note 57.

⁷⁸ See 15 U.S.C. § 77k(b)(3)(A), (C) (2008).

⁷⁹ 15 U.S.C. § 77k(b)(3)(A) (2008).

⁸⁰ Clarke, *supra* note 57.

⁸¹ 15 U.S.C. § 77k(b)(3)(C) (2008); However, a non-expert defendant may remain responsible for unaudited interim financial information. In re WorldCom, Inc. Sec. Litig., 346 F. Supp. 2d 628, 666 (S.D.N.Y. 2004).

⁸² 15 U.S.C. § 77k(c) (2008); The SEC in Rule 176 also provides a list of “relevant circumstances” in which a person’s conduct is considered to be reasonable under section 11(c).

“The list includes the type of issuer, the security, the type of person, the office held if the person is an officer, the presence or absence of another relationship to the issuer if the person is a director, reasonable reliance on officers, employees, or others, the role of the underwriter, the type of underwriting arrangement, and whether the person had any responsibility for a document incorporated by reference into the registration statement.” Clarke, *supra* note 57.

If a director or officer of an investment bank were to be sued on a Section 11 claim for a misrepresented CDO on their registration statement, they would most likely be able to forgo liability with the due diligence defense. Because the process of assessing risk ratings is an expensive and highly complex one, it is in the interest of the business entity to rely on the ratings produced by ratings agencies.⁸³ Further, because the relevant portion of the registration statement would be made “on the authority of an expert”, i.e. the ratings agency, the non-expert directors and officers would not be liable as long as they had “no reasonable ground to believe and did not believe” that a material misstatement or omission existed at the time the registration statement became effective.

2. Section 12(a)(2)

Section 12(a)(2) of the Securities Act creates a private cause of action against “any person who...offers or sells a security” by means of a prospectus or oral communication, which “includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading.”⁸⁴ In order for a plaintiff to succeed in a Section 12(a)(2) claim, the plaintiff must demonstrate that he has standing, and also show (1) an offer or sale of a security, (2) by means of a prospectus or oral communication, (3) that includes an untrue statement of material fact or an omission of a material fact that is necessary to make the statement not misleading, and (4) that the plaintiff did not know the statements were false or misleading at the time of the purchase.⁸⁵

The standing requirement for Section 12(a)(2) is fulfilled by showing that the plaintiff is a purchaser of the security at issue in the initial offering.⁸⁶ Much like Section 11, a Section 12(a)(2) plaintiff does not need to allege reliance on the misrepresentation or omission and does not need to allege scienter on the part of the seller.⁸⁷ When determining whether a statement was false or misleading, only information that was available to an investor at the time of sale should be considered.⁸⁸ Furthermore, like Section 11, the plaintiff does not need to prove causation between the sale and the material misrepresentation or omission.⁸⁹

The defenses available under Section 12(a)(2) are similar to Section 11 defenses.⁹⁰ If the defendant can show that (1) the plaintiff knew the truth of

⁸³ Bianco, *supra* note 6, at 8.

⁸⁴ 15 U.S.C. § 771(a)(2) (2008).

⁸⁵ *Id.*

⁸⁶ See *Gustafson v. Alloyd Co., Inc.*, 513 U.S. 561, 577-78 (1995).

⁸⁷ *Sanders v. John Nuveen & Co.*, 619 F.2d 1222, 1225-26 (7th Cir. 1980); *Hill York Corp. v. America Int'l Franchises, Inc.*, 448 F.2d 680, 695 (5th Cir. 1971).

⁸⁸ *Clarke*, *supra* note 57.

⁸⁹ See, e.g., *Hill York v. American Int'l Franchises, Inc.*, 448 F.2d at 696.

⁹⁰ *Clarke*, *supra* note 57.

the misrepresented or omitted material fact, (2) the misrepresented or omitted fact was not material, or (3) the statute of limitations had been exceeded, then the defendant can escape liability.⁹¹ The defendant can also establish reasonable care and due diligence defenses by showing that the defendant did not know and, through the exercise of reasonable care, could not have known of the misrepresentation or omission of material fact.⁹²

The district court in the Southern District of New York *In re WorldCom, Inc. Securities Litigation* and the SEC have concluded that a defendant's burden to show "reasonable care" under Section 12(a)(2) is lower than the defendant's burden to show a "reasonable investigation" under Section 11.⁹³ One explanation is because Section 12(a)(2) due diligence does not make any distinction based upon expert statements and only requires the defendant to show that she used reasonable care.⁹⁴

When a plaintiff succeeds in establishing a 12(a)(2) claim, the plaintiff is entitled to rescissory damages, or damages if the plaintiff no longer owns the security.⁹⁵ Rescissory damages are calculated as the consideration paid for the security with interest thereon, less the amount of any income received thereon upon tender of the security.⁹⁶

B. Securities Exchange Act of 1934

The Securities Exchange Act of 1934 ("Securities Exchange Act") requires any corporation with more than 500 shareholders and a minimal level of assets to become a reporting company that is required to enter the "continuous disclosure system."⁹⁷ A reporting company is required to file reports annually and quarterly that disclose details to inform securities analysts, institutional investors, shareholders, and investment advisers, who in turn keep the market informed, which adjusts the price of the security to reflect this information.⁹⁸

1. Rule 10b-5

When a director, officer, or any other individual who has access to confidential inside information, trades his shares in the company based on his inside knowledge without disclosing his knowledge to the public, he may be

⁹¹ 15 U.S.C. § 77l(a)(2) (2008).

⁹² *Id.*

⁹³ *In re WorldCom, Inc. Securities Litigation*, 346 F. Supp. 2d 628, 663 (S.D.N.Y. 2004); SEC Release Nos. 33-8591, 34-52056, 70 Fed. Reg. 44,722 at 44,770 (August 3, 2005).

⁹⁴ *WorldCom*, 346 F. Supp. 2d at 663.

⁹⁵ 15 U.S.C. § 77l(a)(2) (2008).

⁹⁶ *Id.*

⁹⁷ KLEIN, *supra* note 43, at 204.

⁹⁸ *Id.* at 205.

liable for insider trading under Rule 10b-5.⁹⁹ In order for a defendant to be liable for insider trading, the following elements must be present: (1) a false or misleading statement or omission; (2) the statement or omission must be material; (3) scienter; (4) the plaintiff bringing the claim must have standing; (5) there must be reliance by the plaintiff on the statement or omission and (6) there must be transaction causation and loss causation.¹⁰⁰

In regard to a false or misleading statement or omission, a failure to disclose is actionable when there is a duty to disclose, but the defendant fails to do so.¹⁰¹ There is no system of continuous disclosure, so corporations are entitled to keep silent, unless positive law creates a duty to disclose.¹⁰² A fact is considered to be material if “there is substantial likelihood that a reasonable shareholder would consider it important” in making an investment decision.¹⁰³

In order for a plaintiff to have standing, the plaintiff must either be a purchaser or seller of securities.¹⁰⁴ For the showing of reliance element, the Supreme Court approved the “fraud on the market” doctrine, which states that a securities fraud plaintiff can satisfy the requirement by claiming that he relied on the integrity of the market price that allegedly reflected the false or misleading information rather than relying directly on the allegedly false or misleading statements at issue.¹⁰⁵ Furthermore, a plaintiff must show both transaction causation and loss causation.¹⁰⁶ Transaction causation requires a plaintiff to show that the violations at issue caused the plaintiff to engage in the transaction.¹⁰⁷ Because a showing of transaction causation depends on a determination that the plaintiff relied on the violation, it is closely intertwined with the reliance element.¹⁰⁸ Loss causation involves a determination that the harm suffered by the investor “flowed” from the misstatement.¹⁰⁹

An example of a plaintiff who failed to establish causation for a 10b-5 claim can be found in the shareholder derivative action brought against Countrywide Financial.¹¹⁰ The plaintiffs alleged that the defendants made sales at inflated prices because of a “host of associated false and misleading

⁹⁹ Clarke, *supra* note 57.

¹⁰⁰ *Id.*

¹⁰¹ Chiarella v. United States, 445 U.S. 222, 230 (1980).

¹⁰² Gallagher v. Abbott Labs., 269 F.3d 806, 808 (7th Cir. 2001).

¹⁰³ TSC Industries, Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976).

¹⁰⁴ Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975).

¹⁰⁵ Basic, Inc. v. Levinson, 485 U.S. 224 (1988); A defense to the showing of reliance can be made by demonstrating that a plaintiff’s decision to purchase or sell shares was not influenced by the alleged misstatements or that the misrepresentations did not distort the price of the stock. Clarke, *supra* note 57.

¹⁰⁶ *Id.*

¹⁰⁷ Robbins v. Koger Props., Inc., 116 F.3d 1441, 1447 (11th Cir. 1997).

¹⁰⁸ AUSA Life Ins. Co. v. Ernst and Young, 206 F.3d 202, 209 (2d Cir. 2000).

¹⁰⁹ See, e.g., Schlick v. Penn-Dixie Cement Corp., 507 F.2d 374, 380-81 (2d Cir. 1974).

¹¹⁰ In re Countrywide Financial Corp. Derivative Litigation, 554 F. Supp.2d. 1044, 1054-55 (C.D. Cal. 2008).

statements” that deceived investors as to “the true financial condition of Countrywide and the nature of the loans that were being originated by Countrywide.”¹¹¹ However, the court denied the plaintiffs’ allegations on insider trading because the plaintiffs failed to show the connection between the insider sales and the repurchase.¹¹² Furthermore, they failed to tie the suspicious insider sales to the timing of the repurchase with any precision or detail.¹¹³

Unlike Section 11 and Section 12(a)(2), there is no due diligence defense for a 10b-5 claim.¹¹⁴ However, a defendant may be able to preclude a finding of scienter by satisfying a due diligence or reasonable care defense under Section 11 or 12(a)(2).¹¹⁵

C. Duty of Care

Although most of the current suits filed against lenders involve the Securities Act and the Securities Exchange Act, some also allege a breach of fiduciary duty. Every director and officer in the United States owes a duty of care and duty of loyalty to his or her company.¹¹⁶ The duty of care is a principle that derives from the law of agency, and requires the agent to perform his duties with care, skill, and prudence of “like persons in a like position.”¹¹⁷ Although the duty of care itself seems straight forward, its enforcement has been more complicated.¹¹⁸ Most cases that have imposed liability on a director or officer involve instances in which corporate officials were suspiciously inattentive to an impending disaster or had a hidden conflict of interest explaining his careless behavior.¹¹⁹

The suit against Countrywide Financial included a duty of care claim, alleging that Countrywide “exacerbated the risky nature” of subprime loans “by offering them to borrowers without requiring them to document their income.”¹²⁰ By approving and offering loans without knowing the creditworthiness of its borrowers, the plaintiffs alleged that Countrywide could “not reasonably know how likely it was that deferred interest on pay option ARMs would ultimately be repaid.”¹²¹ Furthermore, the plaintiffs alleged that

¹¹¹ *Id.* at 1054.

¹¹² *Id.* at 1067.

¹¹³ *Id.* at 1067-68.

¹¹⁴ Clarke, *supra* note 57.

¹¹⁵ See *In re International Rectifier Sec. Litig.*, 1997 WL 529600, *12 (C.D. Cal. Mar. 31, 1997).

¹¹⁶ KLEIN, *supra* note 43, at 150.

¹¹⁷ *Id.*

¹¹⁸ *Id.*

¹¹⁹ *Id.* at 151.

¹²⁰ *In re Countrywide*, 544 F. Supp. 2d at 1054-1055.

¹²¹ *Id.*

in practice, the origination of riskier subprime loans often violated the company's own underwriting policies.¹²²

The duty of care is scrutinized under a gross negligence standard under Delaware case law, and the law presumes that the directors acted honestly and in good faith.¹²³ The acts of the directors and officers are assessed using a balancing legal doctrine known as the business judgment rule.¹²⁴ The business judgment rule shields directors and officers from liability for decisions that in hindsight were bad for the company.¹²⁵ The rule exists because it is generally in the shareholders' interest for the directors to accept some reasonable risks, and courts do not have the ability to assess the risks in a meaningful way.¹²⁶

However, for the directors and officers to enjoy the business judgment rule, they must show that they made an informed decision.¹²⁷ Directors and officers can prove that they made an informed decision by creating a paper record or paper trail evidencing consultation with experts or other documentation that would show that they made a well-advised, well-deliberated decision.¹²⁸ If the directors cannot show that their decision was informed, they can also escape liability by sustaining the burden of proving the "entire fairness" of the transaction they approved.¹²⁹ In order to prove the entire fairness of a transaction, the directors must demonstrate fair price and fair dealing of a transaction.¹³⁰

In the event that a claim related to the subprime mortgage crisis is brought against a director or officer under the duty of care, the defendants will probably not be able to assert the business judgment rule. A plaintiff could bring a claim under the duty of care, and assert that officials were suspiciously inattentive to an impending disaster by alleging that the defendants (1) must have known that the housing market was not keeping up, (2) that borrowers were not able to pay their loans when the interest rates reset, and (3) that many homes were foreclosing. The directors and officers would most likely not be able to assert the business judgment rule because an expert would know of the impending disaster, even if he did not know it would be so detrimental.

However, because Delaware General Corporation Law § 102(b)(7) authorizes shareholders to adopt charter provisions under which directors will be liable only for conduct that involves illegality, a breach of the duty of

¹²² *Id.*

¹²³ KLEIN, *supra* note 43, at 151. The law of Delaware is important for corporations because the majority of large corporations with publicly traded shares are incorporated in Delaware. *Id.* at 145.

¹²⁴ *Id.* at 152.

¹²⁵ *Id.*

¹²⁶ *Id.* at 151-152.

¹²⁷ *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985).

¹²⁸ KLEIN, *supra* note 43, at 153.

¹²⁹ *Cinerama, Inc. v. Technicolor, Inc.*, 663 A.2d 1156 (Del. 1995).

¹³⁰ KLEIN, *supra* note 43, at 151.

loyalty, or intentional misconduct, and not duty of care, directors and officers may still be able to escape liability if they incorporated this provision in their charter.¹³¹ Other states have adopted similar statutes or have redefined the duty of care, making it either a wholly subjective standard, only requiring that the director or officer acted in good faith, or specifying that a director or officer will be liable only if his conduct constitutes willful misconduct or recklessness.¹³² Therefore, even if a director or officer could potentially be liable for a violation of the duty of care, they could easily avoid liability.

D. Duty to Monitor

Within the duty of care is the duty to monitor.¹³³ Under the duty to monitor, a director must understand business, keep herself informed of operations of the company, be familiar with the company's financial status, and inquire into "red flags."¹³⁴ Once a director finds a "red flag," she is then under the duty to investigate the matter.¹³⁵

In the suit against Countrywide Financial, the plaintiffs alleged that a number of committees within Countrywide failed to fulfill their duties to monitor.¹³⁶ The plaintiffs also identified a number of "red flags" that would have provided warning to directors and officers to inquire further.¹³⁷ These include:

- (1) the shift to riskier loan products;
- (2) the rising delinquencies in pay-option ARMs and home equity lines of credit ("HELOCs");
- (3) sharply rising rates of negative amortization and associated 'phantom earnings';
- (4) the 'dramatic increase in retained interests held on Countrywide's balance sheet';
- (5) the fact that the Company's valuation of MSRs, retained interests and loans held for sale 'fluctuated wildly without any basis';
- (6) the pitfalls of other mortgage lenders; and
- (7) industry publications about nontraditional

¹³¹ *Id.*; DEL. CODE ANN. tit.8, § 102(b)(7) (Supp. 1986).

¹³² KLEIN, *supra* note 43, at 153-154.

¹³³ *Id.* at 154.

¹³⁴ *Id.*

¹³⁵ *See In re Caremark International Inc. Derivative Litigation*, 698 A.2d 959 (1996) (requires a duty to establish a legal compliance program).

¹³⁶ *In re Countrywide*, 554 F. Supp. 2d at 1052. This includes the Audit and Ethics Committee, responsible for overseeing the integrity of financial statements and reports and monitoring the Company's exposure to risk; the Credit Committee responsible for overseeing credit objectives and policies, including the review of the Company's credit exposures and loan loss allowances; and the Operations and Public Policy Committee, responsible for overseeing "operational risk" and other matters relating to responsible lending. *Id.*

¹³⁷ *Id.* at 1054-1055.

loans, including those that were critical of low-documentation pay option ARMs.¹³⁸

The court in the Countrywide Financial case denied the defendant's motion to dismiss because the plaintiff showed a strong inference of at least deliberate recklessness for the failure to monitor claims.¹³⁹ Although these are examples given by the plaintiffs in the suit against Countrywide Financial, many, if not most, would apply to other lenders as well.

E. Duty of Loyalty

The duty of loyalty also derives from the law of agency, and imposes an obligation on directors and officers to give their company the utmost loyalty in conducting business.¹⁴⁰ The most common violation of the duty of loyalty is a dealing in which a director or officer conducts a transaction for the benefit of herself.¹⁴¹ In self-dealing transactions, the burden of proving the fairness of the transaction lies with the director.¹⁴² However, the director will not be liable if the transaction was (1) approved by disinterested directors after full disclosure of the conflict, (2) approved by shareholders after similar disclosure, or (3) approved by the court as fair.¹⁴³

The duty of loyalty also requires that an officer turn any opportunities over to the corporation that were offered for consideration to the corporation, or offered in such a context.¹⁴⁴ The officer may take the opportunity for herself only if she first offers it to the corporation with full disclosure and the corporation rejects.¹⁴⁵ The test to determine whether an opportunity is a corporate opportunity is how closely related the opportunity is to an existing line of business in which the corporation is engaged.¹⁴⁶

A recent shareholder derivative suit filed against Merrill Lynch contains a potential duty of loyalty example.¹⁴⁷ Plaintiffs claim that Merrill exerted substantial control over Ownit, a subprime mortgage originator, to feed its CDO machine so it could then encourage and finance loans to

¹³⁸ *Id.*

¹³⁹ *Id.* at 1077.

¹⁴⁰ KLEIN, *supra* note 43, at 164-165.

¹⁴¹ *Id.* at 165.

¹⁴² *Id.*

¹⁴³ Revised Model Business Corporation Act § 8.31; DEL. CODE ANN. tit.8, § 144 (2008).

¹⁴⁴ KLEIN, *supra* note 43, at 167.

¹⁴⁵ *Id.*

¹⁴⁶ *Id.*

¹⁴⁷ Plaintiffs' Consolidated Opposition to Defendants' Motions to Dismiss the Consolidated Amended Class Action Complaint at 14, *In re Merrill Lynch and Co., Inc. Securities, Derivative and ERISA Litigation*, 2008 WL 4342446 (S.D.N.Y. 2008) (No. 07CV9633).

subprime borrowers.¹⁴⁸ In late 2005, Merrill purchased a 20% interest in Ownit and extended Ownit a \$3.5 billion line of credit, and then two-thirds of Ownit's mortgage originations were sold to Merrill.¹⁴⁹ In early 2006, Jonathan Blum, a Merrill Managing Director and the company's designated representative on Ownit's board, instructed Bill Dallas, the President of Ownit, to reduce Ownit's underwriting standards so it could issue more subprime mortgages.¹⁵⁰ This would give Merrill even more product for its CDO machine.¹⁵¹ Despite Dallas' objection to the proposal, Ownit lowered the standards.¹⁵² As a direct result of this action, Ownit declared bankruptcy in December of 2006.¹⁵³

This scenario presents a potential violation of the duty of loyalty because Merrill had acquired enough of an interest in Ownit to exercise control over the company, then instituted policies that would benefit Merrill to the detriment of Ownit. The detriment is obvious after the fact because the company declared bankruptcy after lowering its underwriting standards as instructed by Merrill. However, if the decision was approved by disinterested directors after full disclosure of the conflict, or if the decision was approved by shareholders after similar disclosure, then the directors and officers of Merrill will not be found in violation of their duty of loyalty.

IV. DIRECTORS AND OFFICERS INSURANCE COVERAGE AND EXCLUSIONS

At one time, lawsuits against directors and officers were a rarity and corporations were not permitted to indemnify their directors and officers for loss because the expense was not viewed as a benefit to the shareholders.¹⁵⁴ However, due to a major increase in the number of suits filed against directors and officers, a need for corporations to obtain liability insurance and states to adopt legislation permitting corporations to indemnify officials arose.¹⁵⁵ Corporations obtained D&O insurance so that the top candidates for office would not be discouraged to take the position because of the threat of litigation.¹⁵⁶ The costs that are covered and the method of coverage vary depending on the language of the policy itself, and the courts have continually focused their analysis on the language in the policy.

¹⁴⁸ *Id.*

¹⁴⁹ *Id.*

¹⁵⁰ *Id.*

¹⁵¹ *Id.*

¹⁵² *Id.*

¹⁵³ *Id.*

¹⁵⁴ Lee R. Russ and Thomas F. Segalla, *Risks and Activities Covered by Insurance Policy*, in 9A COUCH ON INSURANCE § 131:30 (3d ed. Thomson Reuters/West, 2008).

¹⁵⁵ *Id.*

¹⁵⁶ *Id.*

A typical clause for D&O insurance provides for 95% coverage of all “loss” (a defined term) for which the insured are “legally obligated” to pay for claims that are made against them for “wrongful acts” (a defined term) in their capacities as directors and officers, subject to the retention amounts and monetary limits on liability applicable to the policy period.¹⁵⁷ D&O insurance policies are generally “claims-made” policies, meaning that in order for a policy to be triggered, the claim or claims must be brought against an insured director or officer during the period covered by the policy.¹⁵⁸ Further, D&O policies typically provide coverage only to individual directors and officers of the insured company, and indirect coverage to corporations that have indemnified their directors and officers for loss in connection with claims made against them.¹⁵⁹

A D&O policy is designed to cover directors and officers with an endorsement protecting the corporation, and is not an expanded comprehensive liability policy that covers a corporation against liability for everything that it does.¹⁶⁰ Therefore, if a claim is not made against a director or officer, a D&O policy cannot be triggered.¹⁶¹ Covered directors and officers must be “duly elected” or “duly appointed,” which the courts have interpreted as meaning that the individual became a director or officer through the regular and proper channels ordinarily followed by the corporation in its hiring, appointment, or election process.¹⁶²

Furthermore, policies often require that “the insured director or officer engaged in the wrongful conduct while acting in his or her capacity as a director or officer of the insuring corporation, often ‘solely’ in that capacity.”¹⁶³ Thus, it has been held that directors and officers who served more than one company, who served also as an attorney for the company, or who acted as a shareholder of the company, were not insured where their wrongful acts were committed while they acted in the capacity of the positions they had with other organizations or outside their scope as director or officer

¹⁵⁷ Joseph Warren Bishop II, *Chapter 8: Directors’ and Officers’ Liability Insurance*, LAW OF CORPORATE OFFICERS AND DIRECTORS: INDEMNIFICATION AND INSURANCE, February 2008, at § 8:6.

¹⁵⁸ David J. Marchitelli, *Annotation, Construction and Application of Directors and Officers Insurance Policy, Exclusive of Exclusion and Notice of Claim Provisions*, 22 A.L.R. 6TH 113 § 2 (2007); This means that the actual loss and wrongful acts that form the basis of liability do not have to occur within the policy period. *Id.*

¹⁵⁹ Russ & Segalla, *supra* note 154.

¹⁶⁰ Bishop, *supra* note 157.

¹⁶¹ This is assuming that the policy does not include Side C entity coverage. *Id.*

¹⁶² Marchitelli, *supra* note 158, at §4; The court in *Sphinx Intern., Inc. v. National Union Fire Ins. Co. of Pittsburgh, Pa.*, applying Florida law, held that although it was shown that the former director had obtained his position by fraudulent means, because he was a “duly elected” or “duly appointed” director, he was therefore an “insured” under the coverage provisions of the policy. 412 F.3d 1224 (11th Cir. 2005).

¹⁶³ Marchitelli, *supra* note 158.

of the insured company.¹⁶⁴ In order for an insurer to establish that an insured did *not* act solely in their capacity as director or officer, and therefore deny coverage, the insurer must not merely rely on allegations made in the underlying complaint, but must offer evidence sufficient to invoke the contractual limitation.¹⁶⁵ Most policies also offer coverage for past and future directors and officers as third party beneficiaries of the contracts with the right to seek enforcement of the provisions and policies under the policy definition of “insured.”¹⁶⁶

A “wrongful act” includes director and officer errors and breaches of duty, but does not include willful or intentional misconduct or injunctive relief or claims sounding in contract.¹⁶⁷ A policy may define a “wrongful act” to be “any actual or alleged error or misstatement or misleading statement or act or omission or neglect or breach of duty by the directors and officers in the discharge of their duties, individually or collectively, or any matter claimed against them solely by reason of their being directors and officers.”¹⁶⁸ The breaches of fiduciary duty include the duty of care, duty to monitor, and duty of loyalty.

“Loss” is defined as “the amount the directors and officers are legally obligated to pay.”¹⁶⁹ To be considered a “loss,” the company must suffer a financial detriment.¹⁷⁰ This includes damages, judgments, settlements,

¹⁶⁴ *Id.* at §5; In *Cincinnati Ins. Co. v. Irwin Co.*, the Ohio Court of Appeals held that where the directors and officers had not sought authorization from the company for a stock buyback and profited from the transaction, the purchase and sale of the stock was made in their personal capacities, rather than in their capacities as directors and officers, and so they were not covered for losses in connection with an underlying shareholder suit. 2000 WL 1867297 (Ohio Ct. App. 1st Dist. Hamilton County 2000).

¹⁶⁵ Marchitelli, *supra* note 158, at §6.

¹⁶⁶ *Id.* at §7.

¹⁶⁷ *Olympic Club v. Those Interested Underwriters at Lloyd's, London*, 991 F.2d 497 (9th Cir. 1993).

¹⁶⁸ Bishop, *supra* note 157.

¹⁶⁹ *Id.*

¹⁷⁰ *Id.*; Although some policies limit coverage to claims for monetary damages and does not cover claims that only seek equitable relief,

insured were entitled to coverage in connection with underlying suits that included damage claims, or could have resulted in damage awards, so where shareholders who sought equitable relief also included a claim for damages in the form of attorney's fees, and where the underlying claimants reserved the right to reinstate a damage claim that had been instituted and later withdrawn, courts have held that the cases involved covered 'loss' that required the insurers to provided coverage for defense costs and any resulting monetary damages.

Marchitelli, *supra* note 155, at §41.

attorney's fees, and other costs incurred in the defense of legal actions.¹⁷¹ "Loss" does not include fines, penalties, exemplary or punitive damages, or a court's order to return stolen property, or any other "ill-gotten gain."¹⁷² Because there must be financial detriment in order for there to be a loss, if an officer cannot suffer a loss based upon statutory immunity, there is no coverage for an insured.¹⁷³

An insurer is only required to cover for losses that are outlined in the policy, and the courts have generally taken the position that whether the duty to defend has been triggered depends on the character of the underlying complaint and the claims alleged therein.¹⁷⁴ It is the insured's burden to show that the underlying complaint and claims alleged fall within the coverage provisions of the policy.¹⁷⁵ After the insured has fulfilled his burden, the burden then shifts to the insurer to establish that an exclusion applies to defeat coverage if possible.¹⁷⁶ However, in practice, an insurer may have a duty to defend even if the underlying complaint and alleged claims involve acts that are usually not covered by the policy.¹⁷⁷ An example of this is a complaint that alleges a number of wrongful acts, including some that could be intentional acts usually not covered by the policy. Despite the fact that the allegations in the complaint were couched in terms of intentional acts, the court cannot speculate as to the merit of the characterizations, and if the facts alleged show any basis for imposing liability that is *within* the policy coverage, the insurer has a duty to defend.¹⁷⁸

Many courts have taken the position that D&O insurance policies are contracts of liability, meaning that an insurer must provide coverage in payment of covered loss as the loss is incurred.¹⁷⁹ This is often an issue with regards to defense costs that can be a daunting amount in director and officer litigation.¹⁸⁰ The courts have come to this conclusion because of the reference

¹⁷¹ Bishop, *supra* note 157.

¹⁷² Level 3 Communications, Inc. v. Federal Ins. Co., 272 F.3d 908 (7th Cir. 2001).

¹⁷³ Bishop, *supra* note 157.

¹⁷⁴ Marchitelli, *supra* note 158, at §§ 19, 20.

¹⁷⁵ *Id.* at § 20.

¹⁷⁶ *Id.*

¹⁷⁷ *Id.* at § 19.

¹⁷⁸ See Lime Tree Village Community Club Ass'n, Inc. v. State Farm General Ins. Co., 980 F.2d 1402 (11th Cir. 1993).

¹⁷⁹ Marchitelli, *supra* note 158, at § 2.

¹⁸⁰ 2008: *The Year in Review*, INSIGHTS (OakBridge, Beechwood, OH), January/February 2009, at 5; Many corporations have been finding themselves confronting an unexpected new challenge with the increased likelihood that defense costs alone may exhaust the entire amount of available D&O insurance coverage. For example, Collins & Aikman bankruptcy and related criminal proceeding accumulated defense expense exhausted the company's entire \$50 million limit in D&O insurance before the criminal case went to trial. *Id.* However, an insurer may be obligated to continue to pay defense costs where a policy is ambiguous as

to D&O insurance policies as “liability” policies, that the policy often states that the insurer would “pay on behalf of” the insured directors and officers, and that the policy described “loss” as any amount that the insured directors and officers are “legally obligated to pay.”¹⁸¹ Other courts have taken the view that contemporaneous defense costs are not required to be paid by the insurer when the language of the policy is silent as to the timing of payment and when the amount of the covered loss cannot be determined without the resolution of factual issues.¹⁸²

The insurer’s duty to provide coverage for defense costs only applies to claims and parties that were covered by the policies.¹⁸³ Furthermore, the courts have concluded that the payment of such costs can be made subject to apportionment between covered and uncovered claims and parties.¹⁸⁴ Apportionment can be postponed until it can be determined which claims are covered and which ones are not.¹⁸⁵ The court justified apportionment in *Gon v. First State Ins. Co.*, by reasoning that a third party complainant, who may overstate its claims against an insured, should not be arbiter of the policy’s coverage and apportioning legal expenses where coverage is not yet clear because the facts have not been fully developed and risks depriving the insured of the benefits of the protection that they purchased.¹⁸⁶

In addition, even though the default rule may state that defense costs must be paid contemporaneously, an insurer can waive such an obligation in the contract itself.¹⁸⁷ Under California law, a liability insurer usually has to pay defense costs contemporaneously, but this rule has not applied where the language of the policy at issue “did not provide for a duty to defend or a duty to pay all defense costs as they were incurred, but rather allowed the insurer the option to advance defense costs relating to claims that the insurer believed to involve persons insured under the policy and loss covered by the policy.”¹⁸⁸

Much like the California court that honored the insurer’s ability to contract out of the default of contemporaneous defense cost payment, the insurer can contract out of and exclude certain coverage from its policies in other areas as well. Although not all policies include the same exclusions, below is a list of common provisions that exclude D&O insurance coverage.

to whether defense costs were to be included in the calculation of the policy limits. Marchitelli, *supra* note 158, at § 45.

¹⁸¹ *Id.* at § 23.

¹⁸² *Id.* at § 28.

¹⁸³ *Id.* at § 24 .

¹⁸⁴ *Id.*

¹⁸⁵ *Id.*

¹⁸⁶ *Gon v. First State Inc. Co.*, 871 F.2d 863 (9th Cir. 1989).

¹⁸⁷ Marchitelli, *supra* note 158, at § 29.

¹⁸⁸ *Id. citing* Commercial Capital Bankcorp. Inc. v. St. Paul Mercury Ins. Co., 419 F. Supp. 2d 1173 (C.D. Cal. 2006).

A. Securities Claim Exclusion

Some D&O policies have an express securities claim exclusion. The common definition of a “securities claim” is a claim alleging a violation of the Securities Act of 1933, the Securities Exchange Act of 1934, any similar state statute or similar common law, or any rules or regulations promulgated thereunder.¹⁸⁹

The securities claim exclusion has been applied in the United States Court of Appeals for the Eighth Circuit, which held that there was no coverage under a D&O policy for claims made against a financial services company and a number of its directors and officers for alleged wrongful acts in connection with the company’s underwriting and sale of certain municipal bonds because the company’s D&O policy included the exclusion.¹⁹⁰ The opinion demonstrates that an insurance policy negotiated between sophisticated parties must be interpreted strictly according to their terms, despite what the common understanding may be about the meaning or operation of policy provisions.¹⁹¹

Because most of the directors and officers litigation arising from the subprime mortgage crisis involves Section 11 and Section 12(a)(2) claims from the Securities Act and Rule 10b-5 claims from the Securities Exchange Act, the inclusion of the securities claim exclusion in a D&O policy will be lethal. Not only will directors and officers not be able to recover for judgments against them, but they will have to reimburse any defense costs that were paid on their behalf to litigate the cases.

B. Dishonesty Exclusion

A typical dishonesty exclusion in a D&O policy states:

[T]he company shall not be liable to make any payment for loss in connection with any claims made against any of the insured persons brought about or contributed to by the dishonesty of such insured person if a judgment or other final adjudication adverse to such insured person establishes that acts of active and deliberate dishonesty or committing or attempting by such insured person with actual dishonest purpose and intent and were material to the cause of action so adjudicated.¹⁹²

¹⁸⁹ Mark E. Miller, *All D&O Policies Are Not Created Equally*, GT ALERT (Greenberg Traurig, Washington D.C.), August 2002, at 3-4.

¹⁹⁰ *In re SRC Holding Corp.*, 545 F.3d 661 (8th Cir. 2008).

¹⁹¹ The D&O Diary, *supra* note 38, Nov. 30, 2008.

¹⁹² Wildermuth, *supra* note 11.

In order for a director or officer to be personally liable, the director or officer must have had a purpose and intent that were material to the cause of action.¹⁹³ In other words, the loss must be “contributed to” by the dishonest acts of the director or officer.¹⁹⁴

Some courts require a final adjudication before coverage is denied.¹⁹⁵ However, others do not require final adjudication, but only a requirement that the conduct occurred and that the insurer denies coverage in good faith.¹⁹⁶

Although it does not appear the subprime losses are a product of affirmative dishonest behavior of the directors and officers, there is still the issue of whether the marketers of the securities concealing information about the risk at the outset or the adverse development materializing constitutes dishonesty as the term is used in the standard D&O policy exclusion.¹⁹⁷ Further, depending on how the complainants present the facts and how courts interpret them, directors and officers may become personally liable for superficially lowering the risk of subprime loans to investors through CDOs and artificial ratings, but only if they had the purpose and intent to be dishonest.

In reality, it is very difficult to prove an allegation of fraud because there is a requirement to show the defendant had intent to deceive.¹⁹⁸ Proving this element beyond a reasonable doubt can be difficult, and although sloppy risk management is lamentable, it is not illegal.¹⁹⁹ To combat this problem, many attorneys have come to rely on e-mail as evidence of intent.²⁰⁰ Because people often forget or disregard how easily messages can be retrieved, and because there is a conversational aspect of e-mail that disillusions individuals to think they are having a casual conversation, indicia of fraudulent intent can often be found in e-mail.²⁰¹

Other difficulties arise in showing that executives deliberately overvalued complex mortgage securities.²⁰² To avoid liability, executives can easily point to the continuing debate over mark-to-market rules, which standards regulators recently relaxed.²⁰³ Some have said that defendants will

¹⁹³ *Id.*

¹⁹⁴ Gerber, Roberto, & Appler, *supra* note 7.

¹⁹⁵ Wildermuth, *supra* note 11; *See also* PepsiCo, Inc. v. Continental Cas. Co., 640 F. Supp. 656, 660 (S.D.N.Y. 1986); *In re WorldCom, Inc. Sec. Litig.*, 354 F. Supp. 2d 455, 460 (S.D.N.Y. 2005).

¹⁹⁶ Gerber, Roberto, & Appler, *supra* note 7.

¹⁹⁷ Wildermuth, *supra* note 11.

¹⁹⁸ *Hunting for Scalps*, THE ECONOMIST, Oct. 23, 2008.

¹⁹⁹ *Id.*

²⁰⁰ Patricia Hurtado & Thom Weidlich, *Ex-Bear Stearns Fund Managers Indicted for Fraud*, BLOOMBERG, June 19, 2008, <http://www.bloomberg.com/apps/news?pid=20601087&sid=aHZnRy9Si0OI&refer=home>.

²⁰¹ *Id.*

²⁰² *Hunting for Scalps*, *supra* note 198.

²⁰³ *Id.*

likely state that they were acting in good faith, based on a faulty understanding of the market, in which they would lack fraudulent intent.²⁰⁴

C. Personal Profits Exclusion

Most D&O policies have a personal profits exclusion that excludes coverage for losses that arise out of, or are attributable to, the insured directors and officers who obtain any personal profit or advantage to which he or she is not legally entitled.²⁰⁵ In such claims, the insurance company must prove that the wrongful conduct actually occurred before coverage can be denied.²⁰⁶ Although it is not known whether a director or officer can be personally liable for the aftermath of the subprime mortgage crisis under this method, it is plausible, considering the fact that between 2001 and 2005, subprime mortgage originations grew from \$173 billion to \$665 billion, meaning that most likely, directors and officers benefited from this dramatic increase.²⁰⁷

A concrete example of a situation in which the personal profits exclusion may apply is Barclays Bank's complaint filed against Bear Stearns.²⁰⁸ The complaint alleges that Bear Stearns manipulated the fund at issue to insulate itself from harsh losses and also used multiple entities in the transaction chain to generate additional fees charged to Barclays or against the fund principal.²⁰⁹ Barclays also alleged that Bear Stearns and its management entity operated the fund deceptively, for their own or their conspirators' gain, in bad faith, and in a grossly negligent manner, contrary to the duties that they owed to Barclays.²¹⁰ Furthermore, while the value of the fund was plummeting in February and March 2007, Barclays alleges that Bear Stearns Senior Manager Ralph Cioffi withdrew millions of dollars of his own money from the enhanced fund, while publicly making optimistic forecasts about the portfolio's prospects.²¹¹

Although it is not certain that the personal profits exclusion will apply, looking at the complaint clearly raises the potential for Bear Stearns and its directors and officers to face personal liability for reimbursing its insurer for any defense costs advanced, and having to pay any damages out-of-pocket.²¹²

²⁰⁴ Hurtado & Weidlich, *supra* note 200.

²⁰⁵ See Commercial Union Ins. Co. v. Auto Europe, L.L.C., 2002 U.S. Dist. LEXIS 3319 (N.D. Ill. 2002).

²⁰⁶ St. Paul Mercury Ins. Co. v. Foster, 268 F. Supp. 2d 1035 (C.D. Ill. 2003).

²⁰⁷ Gerber, Roberto, & Appler, *supra* note 7.

²⁰⁸ Complaint, Barclays Banks PLC v. Bear Stearns Asset Management Inc., et. al. (No. 07-CV-1140 (S.D.N.Y.))

²⁰⁹ *Id.* at 180-181.

²¹⁰ *Id.* at 105.

²¹¹ *Id.* at 138.

²¹² Wildermuth, *supra* note 11.

D. Insured versus Insured Exclusion

The “insured versus insured” exclusion precludes coverage for claims by, or on behalf of, the insured corporation, its affiliates or directors and officers against other insured persons from the same corporation.²¹³ Most policies do not exclude shareholder derivative suits, even though they are technically brought in the name of the insured corporation, but this language must be expressly stated in the policy.²¹⁴ For claims to be covered, they must be “instigated and continued totally independent of, and totally without the solicitation of, assistance of, active participation of, or intervention of” any insured person.²¹⁵

The insured versus insured exclusion may arise if an insolvent company continues business as a debtor-in-possession or has its activities taken over by a receiver.²¹⁶ During the savings and loans crisis in the late 1980s and early 1990s, several hundred failed institutions were placed in receivership with what is now known as the Federal Deposit Insurance Corporation (“FDIC”).²¹⁷ The FDIC equivalent liquidated the assets of the institutions, distributed the proceeds to creditors, and often filed civil lawsuits against directors and officers it believed had “mismanaged” the receivership estate.²¹⁸ Insurers then invoked the insured versus insured exclusion, claiming that suits by receivers against directors and officers were the same as suits within the same covered entity.²¹⁹ However, the court concluded that the policy of the insured versus insured exclusion was to prevent collusive suits, and because the FDIC was genuinely an adverse party to the directors and officers of the receivership estate, the exclusion should not apply.²²⁰ Furthermore, the FDIC did not strictly “step into the shoes” of the failed institution because it could bring suit both as the institution’s successor and as its creditor, as well as on behalf of the institution’s creditors and shareholders, and as subrogee to the depositor’s rights against the institution.²²¹

This means that if suit is brought by the FDIC for failed lending institutions was a result of the subprime mortgage crisis, insurers will most likely not be able to claim the insured versus insured exclusion to preclude coverage of directors and officers. However, if the insurer is able to show that the FDIC did in fact “step into the shoes” of the institution, the insurer may be

²¹³ The D&O Diary, *supra* note 38, Aug. 3, 2008.

²¹⁴ The “Insured v. Insured” Exclusion in D&O Policies, CLIENT ALERT (Latham & Watkins Litigation Department, New York, N.Y.), July 29, 2008, at 1.

²¹⁵ The D&O Diary, *supra* note 38, Aug. 3, 2008.

²¹⁶ *Id.*

²¹⁷ The “Insured v. Insured” Exclusion in D&O Policies, *supra* note 214, at 2.

²¹⁸ *Id.*

²¹⁹ *Id.*

²²⁰ *Id.*

²²¹ *Id.*

able to claim the exclusion.²²² This is so because any recovery by the FDIC would not be to the benefit of the failed institution's depositors, creditors, or shareholders, but solely to the FDIC itself.²²³

E. Regulatory Exclusion

The regulatory exclusion applies to any claims brought by a regulatory agency against a director or officer, including claims brought by regulatory agencies after they take possession of an insolvent lending institution.²²⁴ This situation often arises when the business in question is a bank, because government agencies commonly bring suit against the individual directors and officers.²²⁵

For example, when a state or federal depository institution in the banking industry fails or struggles, the FDIC may be appointed as conservator or receiver.²²⁶ Although there is a public policy argument that the regulatory exclusion impairs the ability of the government to seek redress in situations involving a failed bank, courts have determined that the parties' freedom to contract for the language of a D&O policy overrides the policy argument.²²⁷ However, if the wording of the exclusion is ambiguous, the insured may be able to argue that the regulatory exclusion should not apply.²²⁸

The regulatory exclusion would also apply to SEC civil actions.²²⁹ Therefore, even if a D&O policy does not include a securities claim exclusion, the insurer may be able to exclude coverage through the regulatory exclusion for Section 11, Section 12(a)(2), and Rule 10b-5 claims if the plaintiff is the SEC. Because the bulk of the subprime mortgage-related suits involve these types of claims, this exclusion can prove to be important for directors and officers.

F. Rescission by Insurer

Rescission by the insurer is a common method used by the insurer to avoid coverage under a D&O policy when no other exclusion is applicable. To succeed, the insurer must establish that the statements or misrepresentations made or omitted by the company in the application were (1) material and false at the time, and (2) actually contributed to the increased loss under the

²²² *Id.*

²²³ *Id.* at 3.

²²⁴ *D&O Liability Policies-Regulatory Exclusion*, CLIENT ALERT (Latham & Watkins Litigation Department, New York, N.Y.), July 21, 2008, at 1.

²²⁵ *Id.*

²²⁶ *Id.*

²²⁷ *Id.* at 3.

²²⁸ *Id.*

²²⁹ Miller, *supra* note 189.

policy.²³⁰ Succeeding on a rescission claim can be tricky because of the nature of the marketplace in which changes occur on a daily basis that may impact a stock's value and the corporation's bottom line.²³¹

A misrepresentation is considered to be material if it diminishes an insurer's opportunity to evaluate or estimate risk.²³² The test applied by the courts is whether reasonable insurers would regard the fact as one that substantially increases the chance that the risk insured against will happen and, therefore, would reject the application.²³³

Common law creates a duty of disclosure by the insured in connection with the purchase of insurance.²³⁴ The duty arises either out of the fiduciary nature of the insurance relationship or from the equitable principle that in all express contracts, there is an implied warranty that neither party will make material misrepresentations to the other concerning the subject matter of the contract.²³⁵

In practice, if the insurer did not ask for information in the insurance application or otherwise, such information is determined to be immaterial.²³⁶ This also implies that if an insurer specifically asks for information on the application, the matter is deemed to be material.²³⁷ When an insurer seeks to rescind a policy based on the insured's failure to disclose information that was not required on the application form, the insurer must prove that the concealment was both material *and* fraudulent.²³⁸ If there is ambiguity whether particular information was asked on the application, the ambiguity is resolved in favor of the insured, and an insurer is presumed, in its specific questions, to have requested all of the information that it believed to be material.²³⁹

During a rescission procedure, the insurer must continue to make contemporaneous payments for defense costs if it is required to do so under the policy, until the issue of rescission has been adjudicated.²⁴⁰ The United States District Court for the Southern District of New York has rejected the argument made by an insurer that its obligation to advance defense costs ended when it

²³⁰ Wildermuth, *supra* note 11; TIG Ins. Co. of Michigan v. Homestore, Inc., 40 Cal. Rptr. 3d 528 (Cal. App. 2d Dist. 2006).

²³¹ Wildermuth, *supra* note 11.

²³² Berger v. Minn. Mut. Life. Ins. Co., 723 P.2d 388 (Utah 1986).

²³³ Wildermuth, *supra* note 11.

²³⁴ Allan D. Windt, *Rescinding Policy-Based on Concealment of Material Information Not Encompassed by Application*, in 1 INSURANCE CLAIMS AND DISPUTES: REPRESENTATION OF INSURANCE COMPANIES AND INSURED § 2:27 (Thomson Reuters/West 2008).

²³⁵ *Id.*

²³⁶ *Id.*

²³⁷ Wildermuth, *supra* note 11.

²³⁸ Windt, *supra* note 234.

²³⁹ *Id.*

²⁴⁰ Marchitelli, *supra* note 158, at § 26.

gave notice to the insured that the policy was void, and that the insured had the burden to show that the insurer's rescission argument would fail.²⁴¹

Therefore, if a D&O insurer asked about an insured's MBS, and the insured either misrepresented or omitted the risky pieces, the insurer could have a claim for rescission of the policy. Further, if an insurer asked about the financial status of the insured company, and the insured either misrepresented or omitted risky subprime mortgages from their account balances, the insurer could also rescind its coverage and directors and officers could become personally liable.

V. CONCLUSION

Although D&O insurance is bought to protect directors and officers from incurring personal liability, there are many exclusions that could apply in lawsuits relating to the subprime mortgage crisis. Because courts will honor the language of the D&O policy at issue, if the policy clearly outlines an exclusion, that exclusion will be followed.

Of course, some claims in which directors and officers could potentially be liable, such as the failure to fulfill the duty to monitor and violation of the duty of loyalty, may fall under coverage of D&O insurance, in which case there would be no personal liability unless the amount in damages exceeds the amount covered by the policy. However, considering most of the present subprime mortgage-related suits involve violations of the Securities Act of 1933 or violations of the Securities Exchange Act of 1934, if a D&O policy contains a securities claim exclusion, the director or officer likely will incur a detrimental amount in personal damages. On a similar note, if a D&O policy contains a regulatory exclusion and the SEC is a party to the lawsuit, a director or officer will become personally liable for the damages and defense costs in this way, as well. A director or officer may also incur personal liability if the D&O policy includes a dishonesty exclusion, personal profits exclusion, or insured versus insured exclusion. Further, if there is no exclusion applicable, an insurer may try to rescind the policy by claiming that there was a material misrepresentation or omission in the insurance application.

Therefore, if a director or officer wants to avoid personal liability in a subprime mortgage crisis suit, they must meticulously go over the provisions of their D&O policy to ensure that undesirable exclusions are not contained within. They should also take care to complete due diligence and consult experts when necessary. Unfortunately, for many of the subprime mortgage lenders, this advice comes far too late, and it will be newsworthy to see how much damage directors and officers will actually incur as the judgments come out.

²⁴¹ *In re WorldCom, Inc. Securities Litigation*, 354 F. Supp. 2d 455 (S.D.N.Y. 2005).

